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## Standby Letters of Credit and Penalty Clauses: An Unexpected Synergy

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### I. INTRODUCTION

It has been the traditional rule in the United States that a liquidated damages clause is unenforceable if it is so unreasonable as to constitute a penalty.<sup>1</sup> If the liquidated damages clause represents a reasonable pre-estimate of probable future losses, it will normally be upheld; if it represents an excessive pre-estimate, it will be invalidated as a penalty.<sup>2</sup> Although this rule seems to have evolved from the law of unconscionability, the unenforceability of penalty clauses has long since hardened into a separate and distinct rule of law.<sup>3</sup> Thus a penalty will not be enforced *whether or not* unconscionability can be demonstrated. How this traditional rule works can be seen from the following illustration:

X, a major East Coast builder, agrees to construct a plant for Y, a large equipment manufacturer on the West Coast. In the contract, X and Y set the price of the construction at \$35,000,000. Y, however, demands that X agree to an \$8,000,000 "liquidated damages" clause in the event of X's default. Assume that the amount demanded is not a reasonable pre-estimate of Y's probable future losses and clearly constitutes a penalty. Although fully aware of the penal nature of the clause, X voluntarily agrees to it because he wants to win the lucrative contract. Before X begins construction, however, A approaches X and offers X \$40,000,000 to build a similar plant. Since X has limited capacity, he cannot build both plants. X decides to repudiate his contract with Y and build the plant for A.

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1. See, e.g., 5 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 776, at 667-70 (3d ed. 1961).

2. For the factors that are considered in determining whether a stipulated damages clause is an invalid penalty or a valid liquidated damages clause, see J. CALAMARI & J. PERILLO, CONTRACTS § 14-31, at 565-67 (2d ed. 1977) [hereinafter cited as CALAMARI & PERILLO]. The most important consideration, however, is whether the amount stipulated is a reasonable pre-estimate of probable future losses. *Id.* at 565. The Restatement (Second) of Contracts, however, validates a liquidated damages clause if the amount stipulated is reasonable in the light of either anticipated or actual loss caused by the breach. RESTATEMENT (SECOND) OF CONTRACTS § 356(1). See also U.C.C. § 2-718(1) (1978 version).

3. CALAMARI & PERILLO, *supra* note 2, § 9-38, at 318-19. Occasionally there are judicial intimations that substantial stipulated damages amounts should be permitted absent a showing of unconscionability or coercion. See *Gruschus v. C.R. Davis Contracting Co.*, 75 N.M. 649, 655, 409 P.2d 500, 504 (1965).

Because of X's breach, Y hires V construction company to build his plant for \$36,000,000 and sues X for the stipulated damages of \$8,000,000. X sets up as a defense the penal nature of the stipulated damages clause.

Under normal circumstances the law will require X to pay Y only \$1,000,000—the difference between the contract price of \$35,000,000 and the cost of Y's substituted performance, \$36,000,000.<sup>4</sup> The law will not enforce the penalty even though X voluntarily and willingly agreed to it. In essence, by breaching, X will achieve a net gain of \$4,000,000; he will receive \$5,000,000 more from A than from Y and will have to pay Y only \$1,000,000 in damages.

Both Holmes' compensation theory of contract law<sup>5</sup> and conventional economic wisdom<sup>6</sup> support this result. Economists argue that legal rules should maximize net social gain. By not enforcing the penalty (i.e., by requiring X to compensate Y only for *losses* caused by the breach), X will be encouraged to perform the more advantageous contract, thus creating a net social gain of \$4,000,000. This result has been dubbed the theory of "efficient breach."<sup>7</sup> In recent years, however, two theorists, Goetz and Scott, have questioned this economic analysis, arguing that in a world where penalty clauses are enforced, economic efficiency will still be achieved.<sup>8</sup> If the enforcement of penalty clauses can be shown to be efficient, society would reap the added dividend that the X's of such a world would be required to live-up to their bargains. Morality and efficiency would thus be merged.

This Article suggests that perhaps there is no need to posit such a fanciful world—that world may be with us here and now. Through the use of standby letters of credit—a much used adjunct of many business transactions—penalty clauses may be rendered enforceable.<sup>9</sup> In order to develop this analysis, Part II of this Article briefly explains what a standby letter of credit is and, more importantly, how it functions in the overall business transaction. Part III analyzes how the standby letter of credit can act to enforce a penalty clause in an underlying contract and shows that once a bank pays an amount of money pursuant to standby letter of credit, various factors may combine to block recovery of the amount paid even though the amount paid constitutes a penalty. Part IV demonstrates that, even if one accepts this conclusion, standby

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4. Consequential damages and damages resulting from the delay may also be recovered by Y if and when they exist. In the subsequent analysis, however, these damages will be disregarded.

5. See, e.g., Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

6. See R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 4.9, at 89-90 (2d ed. 1977).

7. Professor Linzer attributes the first use of this term to Professors Goetz and Scott. Linzer, *On the Amoralization of Contract Remedies—Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111, 114 n.13 (1981).

8. Goetz and Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977). See text accompanying notes 108-11 *infra*.

9. See Gable, *Standby Letters of Credit: Nomenclature Has Confounded Analysis*, 12 LAW & POL'Y INT'L BUS. 903, 942-43 (1980). Gable briefly mentions the fact that, due to political factors in a foreign country, international standby letters of credit can, as a practical matter, enforce penalty clauses. See note 93 *infra*.

letter of credit law still does not preclude the theory of efficient breach from operating. In other words, properly understood, contracting parties can employ letter of credit law and penalty clauses to achieve fair and efficient results.

## II. THE STANDBY LETTER OF CREDIT

In order to appreciate how a standby letter of credit operates, it is necessary first to understand what a letter of credit is and second to understand the difference between the two forms of letters of credit—the commercial letter of credit and the standby letter of credit.

### A. *Letters of Credit in General*

In pertinent part, the Uniform Commercial Code (the Code)<sup>10</sup> defines a letter of credit as “an engagement by a bank . . . made at the request of a [bank’s] customer . . . that the [bank] will honor drafts or other demands for payment upon compliance with the conditions specified in the credit.”<sup>11</sup> Since most bank letters of credit are irrevocable,<sup>12</sup> by issuing them in favor of a named individual the bank undertakes an irrevocable payment obligation with respect to this individual. The irrevocable nature of the bank’s payment commitment is the hallmark of the letter of credit. The significance of this commitment, however, can be understood only in the context of an overall business transaction.

Obviously a letter of credit is not issued in a vacuum; it is always part of a larger deal between contracting parties.<sup>13</sup> Three separate contracts are re-

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10. Unless otherwise noted, all citations to the Uniform Commercial Code are to the 1978 Official Text.  
11. U.C.C. § 5-103(1)(a). The full text of the section reads:

“Credit” or “letter of credit” means an engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Article (Section 5-102) that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit.

A letter of credit can thus be issued by banks as well as non-banks. Throughout this Article, however, reference will be made only to letters of credit issued by banks.

For the scope of Article 5, see U.C.C. § 5-102(1). Article 5, however, may not always apply to the letter of credit transaction. New York, for example, has added the following subsection to U.C.C. § 5-102:

Unless otherwise agreed, this Article 5 does not apply to a letter of credit or a credit if by its terms or by agreement, course of dealing or usage of trade such letter of credit or credit is subject in whole or in part to the Uniform Customs and Practice for Commercial Documentary Credits fixed by the Thirteenth or by any subsequent Congress of the International Chamber of Commerce. N.Y. U.C.C. § 5-102(4) (McKinney 1964).

Thus, the Uniform Customs and Practice for Commercial Documentary Credits might often govern commercial and standby letters of credit. This Article will cite only to letter of credit law contained in Article 5 of the Code, not to letter of credit law contained in the Uniform Customs and Practice for Commercial Documentary Credits. The thesis of this Article, however, would not be changed if the Uniform Customs and Practice governed the transaction. For a copy of the Uniform Customs and Practice, see INTERNATIONAL CHAMBER OF COMMERCE, PUBLICATION NO. 290 (1974).

12. J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 18-4, at 721 (2d ed. 1980).

13. For brief and lucid discussions of letter of credit law, see *id.* at Chapter 18; Squillante, *Letter of Credit: A Discourse* (pts. I-III), 84 COM. L.J. 372, 426, 474 (1979), (pts. IV-VIII), 85 COM. L.J. 48, 89, 145, 177, 220 (1980).

quired for a letter of credit to issue.<sup>14</sup> Contract I typically involves an underlying agreement between two parties wherein one of the parties undertakes a payment obligation. For example, seller agrees to ship buyer \$200,000 worth of widgets; buyer, in return for the seller's promise, agrees to pay seller \$200,000 for the widgets. An underlying contract has been entered into, with buyer undertaking a payment obligation. For reasons to be discussed below, the seller may prefer the payment obligation to run from a bank rather than from the buyer. To substitute a bank's obligation for his, the buyer will approach a bank and contract with it to issue an irrevocable letter of credit for \$200,000 in favor of the seller (Contract II). The buyer, however, will specify in his contract with the bank that the bank is to pay the letter only if certain conditions are met. If the bank agrees, it will issue an irrevocable letter in favor of the seller (Contract III), committing itself to honor seller's drafts for \$200,000, assuming, of course, that the specified conditions are met.<sup>15</sup> Contract III thus substitutes the payment obligation of the bank for that of the buyer.<sup>16</sup>

What is important about this arrangement is that each of these three contracts is separate and involves different parties. Contract I is between buyer and seller; Contract II is between buyer (dubbed "the customer" by Article 5 of the Code)<sup>17</sup> and the bank (dubbed "the issuer");<sup>18</sup> and Contract III is between the bank ("the issuer") and the seller (dubbed "the beneficiary").<sup>19</sup> Not only are these three contracts separate from each other, but they are also independent of each other. This means, for example, that disputes with respect to Contract I between buyer and seller cannot affect the issuing bank's payment obligation towards the seller/beneficiary under Contract III.<sup>20</sup>

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14. See *Dynamics Corp. of America v. Citizens & S. Nat'l Bank*, 356 F. Supp. 991, 995, 12 U.C.C. Rep. Serv. 317, 322 (N.D. Ga. 1973), for the model for this analysis. The author, however, has reversed the order of Contracts I and II in the case. In addition, see Justice, *Letters of Credit: Expectations and Frustrations—Part I*, 94 BANKING L.J. 424, 425 (1977).

15. The irrevocable commercial letter of credit may also be "confirmed" by a local bank in seller's area. Since the issuing bank will usually be in the buyer's locale, the seller may also wish to receive a payment commitment from a bank in his locale. Hence, a confirmed irrevocable commercial letter of credit has the payment commitments of two banks behind it. See U.C.C. §§ 5-107(2) and 2-325(3). See also H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 214 (5th ed. 1974).

16. Some have suggested that it may be a misnomer to call this Contract III a true contract. See, e.g., J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 18-2, at 711 (2d ed. 1980).

17. U.C.C. § 5-103(g).

18. U.C.C. § 5-103(c).

19. U.C.C. § 5-103(d).

20. See, e.g., U.C.C. § 5-114, Official Comment I and *American Bell Int'l, Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420, 424 (S.D.N.Y. 1979). The only exceptions to this rule exist in U.C.C. § 5-114(2). "Forged or fraudulent" documents or "fraud in the transaction" (i.e., in Contract I) can affect the issuer's obligation to pay under Contract III. With respect to "fraud in the transaction," section 5-114(2) seems to have codified the rule in *Sztejn v. Schroder Banking Corp.*, 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941). There is some dispute, however, whether the fraud referred to in § 5-114(2) refers to fraud in Contract I or fraud in Contract III. See *American Bell Int'l, Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420, 424 (S.D.N.Y. 1979).

### B. *The Commercial Letter of Credit and the Standby Letter of Credit*

Letters of credit are commonly classified according to the functions they serve in the overall business transaction. The oldest form of letter of credit is the so-called commercial letter of credit—"a mechanism of payment utilized in a transaction involving the sale of goods."<sup>21</sup> The commercial letter evolved to meet the legitimate needs of international commerce. A foreign seller deciding whether to sell goods to an American buyer will usually prefer payment before shipment.<sup>22</sup> Advance payment reduces most of the seller's transactional risks, such as potential buyer insolvency, payment delays due to warranty disputes, intervening currency fluctuations,<sup>23</sup> or unexpected occurrences such as the imposition of exchange controls or embargoes. But just as advance payment reduces the foreign seller's risks, it has the opposite effect of creating risks for the buyer. For example, if the buyer pays in advance, there is no guarantee that the seller will in fact ship the goods as promised. The irrevocable commercial letter of credit, however, substantially reduces the mutual concerns of both buyer and seller.<sup>24</sup> By using the letter, the buyer can guarantee that the seller will not be paid until there is proof that the goods are en route: a typical commercial letter of credit conditions payment on the presentation to the bank of a bill of lading evidencing that the goods have been shipped.<sup>25</sup> On the other hand, the seller can assure himself that potential warranty disputes involving the goods will not delay payment: the bank's obligation to pay the seller under Contract III is not affected by disputes between the buyer and seller relating to Contract I. Similarly, fears of buyer insolvency are lessened because a bank has now committed itself to pay. Also, since the seller will be paid soon after shipment of the goods, not upon their arrival at a foreign destination, the time within which currency fluctuations or unexpected events can occur is reduced.

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21. Arnold and Bransilver, *The Standby Letter of Credit—The Controversy Continues*, 10 U.C.C. L.J. 272, 277 (1978). Of course, commercial letters of credit can serve a financing function as well as a payment function. See Harfield, *Secondary Uses of Commercial Credits*, 44 COLUM. L. REV. 899 (1944).

22. For a more detailed discussion of the risks faced by sellers and buyers in a typical international sale of goods, see A. LOWENFELD, *INTERNATIONAL PRIVATE TRADE* 2-3 (1977); J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 18-1, at 704-08 (2d ed. 1980).

23. For a discussion of the risks of currency fluctuation with respect to the international sale, see H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 23-24 (5th ed. 1974).

24. The Code's definition of a letter of credit is quite broad. The definition can include such devices as authorities to purchase drafts and authorities to pay drafts. See U.C.C. §§ 5-102(1), 5-102(2), and 5-103(1)(a). See also Official Comment 1 to § 5-103; Harfield, *Practice Commentary*, N.Y. U.C.C. § 5-102 (McKinney, 1964).

25. As a precondition for paying the draft, an ordinary commercial letter of credit will require the presentation of an invoice (a representation by seller of the nature of the goods shipped), a bill of lading (a transit receipt for the goods provided by shipper) and some form of transit risk insurance policy. Sometimes other papers such as export or import licenses are also required.

For a discussion of the usual documents required as a precondition for paying a commercial letter of credit, see Articles 14 to 33 of the Uniform Customs and Practice for Commercial Documentary Credits, *supra* note 11.

The standby letter of credit<sup>26</sup> functions differently from the commercial letter of credit. The latter is used in the sale of goods transaction as a payment device; the former is used in the non-sales transaction as a "guarantee" against default on contractual obligations.<sup>27</sup> Depending on the circumstances, contractual obligations are either financial or non-financial in nature—that is, a contracting party will obligate himself either to pay a sum of money or to do or refrain from doing an act.

When the contracting party has obliged himself to pay money, the standby letter will add the obligation of the bank to the obligation of the party. For example, a creditor may loan money to a debtor on certain terms. Although the debtor will promise to repay the loan, the creditor may demand a greater assurance of repayment. The creditor may request the debtor to have a bank issue in the creditor's favor an irrevocable standby letter of credit for the amount of the loan.<sup>28</sup> Thus, if the debtor defaults on his payment obligation, the creditor can turn to the bank's standby or "backup" obligation. Here the standby letter of credit "guarantees" performance of a financial obligation—repayment of a loan—and thus functions as a "repayment guarantee."<sup>29</sup>

When a contracting party has obliged himself, on the other hand, to perform an act, the standby letter will add the financial obligation of the bank to the performance obligation of the party. In other words, if the party fails to perform, the bank will pay the beneficiary of the letter a stipulated amount of money to compensate for this failure of performance. For example, in the ordinary construction contract (forgetting for a moment the added complication of a penalty clause), Y, who wants a plant built, may desire that X, the builder, give him some assurance that if there is a default, Y will be able to recover his damages from X without protracted litigation. To satisfy Y, X will agree that a certain amount of money be paid in the event of default and then will contract with a bank to issue in Y's favor a standby letter of credit in

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26. A definition of a standby letter of credit has been provided by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation. The Comptroller defines the standby letter as a letter of credit "which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party or (2) to make payment on account of any evidence of indebtedness undertaken by the account party, or (3) to make payment on account of any default by the account party in the performance of an obligation." 12 C.F.R. § 7.1160(a) (1980). See also 12 C.F.R. §§ 208.8(d) (1) and 337.2(a) (1980). Standby letters of credit are sometimes called suicide letters of credit, back-up letters of credit, or guarantee letters of credit.

27. A standby letter can sometimes appear in a sale of goods transaction not as a payment device but as a guarantee that the seller will either ship the goods or perform certain contractual obligations. See, e.g., *Dynamics Corp. of America v. Citizens & Southern Nat'l Bank*, 356 F. Supp. 991, 12 U.C.C. Rep. Serv. 317 (N.D. Ga. 1973).

For a brief review of some of the situations in which the standby letter has been utilized, see Joseph, *Letters of Credit: The Developing Concepts and Financing Functions*, 94 BANKING L.J. 816 (1977).

28. See, e.g., *New Jersey Bank v. Palladino*, 77 N.J. 33, 389 A.2d 454 (1978); *Barclays Bank D.C.O. v. Mercantile Nat'l Bank*, 481 F.2d 1224, 1226-27 (5th Cir. 1973). The standby letter in this case was issued by a non-bank. But see *id.* at 1226 n.2 (Mercantile National Bank was a confirming bank under the U.C.C.).

29. In the United States, except in very limited circumstances, a bank cannot legally act as a surety or guarantor. See Gable, *Standby Letters of Credit: Nomenclature Has Confounded Analysis*, 12 LAW & POL'Y INT'L BUS. 903, 914-15 (1980); Lord, *The No-Guaranty Rule and the Standby Letter of Credit Controversy*, 96 BANKING L.J. 46, 47 (1979). There are differences between an impermissible bank guarantee and a permissible bank standby letter of credit. These differences, however, sometimes seem more formal than real. *Id.* at 61-62.

the agreed-upon amount.<sup>30</sup> In the event of X's default, Y can present his draft to the bank along with appropriate documentation attesting to X's default and recover the stipulated amount of money.<sup>31</sup> Thus the bank's financial obligation to pay damages guarantees the performance obligation of the builder. Here the standby letter serves as a "performance bond" since it "guarantees" quick payment in the event of default.

### III. THE INTERACTION OF THE STANDBY LETTER OF CREDIT AND A PENALTY CLAUSE

In order to focus on how a standby letter of credit may act to enforce a penalty clause, let us analyze in more detail the construction contract posited at the beginning of this Article. Assume that in the contract between X and Y, Y requires X to procure a standby letter of credit issued by an East Coast bank naming Y as beneficiary. The letter will guarantee Y payment of the penalty amount of \$8,000,000 should X repudiate or default on his promise to build the plant.<sup>32</sup> Here, of course, the standby letter will act as a form of performance bond. Assume X (the customer) now procures a standby letter from the issuing bank. The letter, if it is a typical standby letter, will obligate the issuing bank to honor drafts drawn by Y up to \$8,000,000 on Y's presentation to the bank of a written notice stating that X has defaulted on the underlying contract. When X repudiates his contract with Y, Y will draw a draft on the bank for \$8,000,000, attaching to it the written notice stating that X has refused to perform the contract. At this point, subsequent events must be considered in detail.

May the issuer (the bank) refuse to pay the draft, claiming that since the amount sought by Y constitutes a penalty, the issuer need not honor Y's draft? In this situation, letter of credit law requires the issuing bank to honor its irrevocable commitment to Y regardless of the fact that the \$8,000,000 constitutes a penalty.

Section 5-114(1) of the Code states that "an issuer must honor a draft or demand for payment which complies with the terms of the relevant credit" regardless of disputes with respect to the underlying contract.<sup>33</sup> Thus the issuing bank must keep its payment obligation to Y (Contract III) separate and independent from any transactional disputes between its customer and Y

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30. For examples of construction contracts in which standby letters were used, see *Parsons & Whittemore Overseas Co. v. Societe Generale de L'Industrie du Papier (RAKTA)*, 508 F.2d 969, 972 (2d Cir. 1974); Comment, *Recent Extensions in the Use of Commercial Letters of Credit*, 66 YALE L.J. 902, 909 (1957).

31. A standby letter of credit may sometimes be a "clean" letter—that is, a letter the payment of which is conditioned on presenting a draft but no documents. See the "clean" letter in *Werner Lehara Int'l, Inc. v. Harris Trust & Sav. Bank*, 484 F. Supp. 65, 67 n.1 (W.D. Mich. 1980). One commentator defines a "clean" letter as "payable against a draft or other demand that is accompanied by some written representation that the beneficiary is entitled to payment." H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 68 (5th ed. 1974).

32. A standby letter of credit secured a penalty in *Parsons & Whittemore Overseas Co. v. Societe Generale de L'Industrie du Papier (RAKTA)*, 508 F.2d 969, 972 (2d Cir. 1974). See also H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 68 (5th ed. 1974).

33. U.C.C. § 5-114(1).

(Contract I).<sup>34</sup> Section 5-114(2), however, recognizes limited exceptions to this general rule. If a document which is required to be presented as a condition of payment is either "forged or fraudulent" or there is "fraud in the transaction," the issuing bank may validly refuse to honor the beneficiary's draft.<sup>35</sup> In the ordinary standby letter transaction, Y must present to the issuing bank a written notice of X's default as a condition of payment. Since X did, in fact, default on the contract, any notice of default submitted by Y would not be "fraudulent" and, if signed by Y, would not be "forged." With respect to the final exception, the presence of a penalty clause in the underlying contract between X and Y would hardly constitute fraud in that transaction. Thus the issuing bank's obligation to pay Y the penalty amount seems clear.

If the issuing bank refused to honor its obligation, claiming that the presence of the penalty excused its duty to honor Y's draft, Y could successfully sue the bank and force it to honor its irrevocable commitment. For example, in *New York Life Insurance Co. v. Hartford National Bank & Trust Co.*,<sup>36</sup> the issuing bank refused to honor a draft for \$180,000, claiming, among other things, that a liquidated damages clause in the underlying contract was "illegal" and unenforceable.<sup>37</sup> The Supreme Court of Connecticut rejected the issuer's refusal to pay the draft, emphasizing in strong terms the independence of Contract III (issuer-beneficiary) from Contract I (customer-beneficiary):

[T]he question whether this . . . liquidated damages clause was a penalty [was a claim] relating to the mortgage loan commitment contract between [customer and beneficiary] which, as discussed previously, was entirely separate and independent from the letter of credit arrangement involving [issuer and beneficiary]. In the present case, these allegations were not proper defenses to the issuer's obligation to honor the draft pursuant to the letter of credit.<sup>38</sup>

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34. See note 20 *supra*. This central point of letter of credit law has been expressed in a different way in H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 28 (5th ed. 1974):

It is essential at the outset . . . to recognize the fundamental precept of commercial credit banking, which is that the banker approaches the mercantile transaction from the outside, remains on the outside, and is bound and governed only by the contract which he himself makes and not by the contract which the commercial parties may have made.

35. U.C.C. § 5-114(2).

36. 173 Conn. 492, 378 A.2d 562, 22 U.C.C. Rep. Serv. 761 (1977). See also *Prudential Ins. Co. v. Marquette Nat'l Bank*, 419 F. Supp. 734 (D. Minn. 1976). Compare *Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank of San Francisco*, 493 F.2d 1285 (9th Cir. 1974), in which the court found that what appeared to be a letter of credit was in fact a guaranty contract. Since a guarantor (the bank) can utilize the defenses available to the one for whom the guarantee was issued, the bank could claim in defense that the stipulated damages amount to be paid constituted an unenforceable penalty. The court, however, found the stipulated penalty amount to be a valid liquidated damages clause. Interestingly, no mention was made of the validity of banks acting as guarantors. See note 29 *supra*.

37. *New York Life Ins. Co. v. Hartford Nat'l Bank & Trust Co.*, 173 Conn. 492, 501, 378 A.2d, 562, 567, 22 U.C.C. Rep. Serv. 761, 768 (1977).

38. *Id.* at 502, 378 A.2d at 567, 22 U.C.C. Rep. Serv. at 769 (1977). On this point, see also *Prudential Ins. Co. v. Marquette Nat'l Bank*, 419 F. Supp. 734 (D. Minn. 1976), and the dictum in *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10, 16 (2d Cir. 1979). In *New York Life Insurance*, the bank perhaps could have developed a different argument to support dishonoring the beneficiary's draft. Section 5-103(4) of the Code states that Article 1's principles of construction and interpretation are to be applied to Article 5. Section 1-106(1) denies a party recovery of penal damages except as provided by the Code or by other rule of law. Since Article 5 governs the agreement between issuer and beneficiary (Contract III), no penal damages growing out of this contract can be enforced. In our hypothetical, however, penal damages arise out of Contract I, not out of Contract III. Thus the bank could not utilize this argument since the penalty is in Contract I, not in Contract III.



In defending its refusal to honor the draft, the issuer in *New York Life Insurance* characterized the penalty clause as illegal. This is perhaps too strong a characterization; historically the prohibition against enforcing penalty clauses evolved from the law of unconscionability, not from the law of illegality.<sup>39</sup> But even if one were to accept *arguendo* the characterization, the illegality of the payment in terms of the underlying contract (Contract I) normally will not constitute a defense for the issuing bank. The issuer can use the defense of illegality only when the letter of credit contract itself (Contract III) is "unenforceable as a result of its own illegality, as contrasted with that of the underlying transaction."<sup>40</sup> If one contrasts the facts in *New York Life Insurance* with the facts in *International Dairy Queen v. Bank of Wadley*,<sup>41</sup> this distinction becomes clear. In *International Dairy Queen*, plaintiff-beneficiary sued an issuing bank for refusing to honor plaintiff's draft drawn under the bank's letter of credit. Defending its refusal to honor the draft, the bank cited to an Alabama statute that limited the amount of money a bank could lend to a single borrower. By honoring the draft, the issuing bank claimed it would have exceeded these statutory limitations with respect to its customer.<sup>42</sup> The court agreed with the bank and accepted the defense of illegality, but only because the illegality affected performance of the letter of credit contract itself. On the other hand, in *New York Life Insurance* the obligation for the issuing bank to pay \$180,000 was not in itself illegal. The illegality, if any, existed in the underlying agreement between the customer and the beneficiary.<sup>43</sup>

If the issuing bank must honor the beneficiary's draft for the penalty amount, can the customer enjoin the bank from paying the draft? The U.C.C. severely restricts the ability of the customer to enjoin the bank from honoring its letter of credit commitments. An injunction is permissible only when a document presented is forged or fraudulent or when there is fraud in the underlying transaction.<sup>44</sup> Fraudulent or forged documents will usually not be an issue in our hypothetical construction contract. As for fraud in the underlying transaction, since both X and Y were aware of the penal nature of the liquidated damages clause, X would be hard pressed to make out even a

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39. See note 3 *supra*.

40. Kozolchik, *Letters of Credit*, in INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW, Vol. IX, *Commercial Transactions and Institutions* § 5-216 (1979).

41. 407 F. Supp. 1270 (M.D. Ala. 1976). *Contra* First American Nat'l Bank of Iuka v. Alcorn, Inc., 361 So. 2d 481, 488-90 (Miss. 1978).

42. For a criticism of the result in this case, see Justice, *Letters of Credit: Expectations and Frustrations—Part I*, 94 BANKING L.J. 424, 433-35 (1977).

43. Although as a conceptual matter the illegality of the underlying contract—no matter how serious—should not affect the bank's obligation to pay, at some point the underlying illegality will undoubtedly permit an issuing bank to refuse payment. This is only common sense. Where that point is will undoubtedly depend on the seriousness of the illegal act secured by the standby letter. See Kozolchik, *Letters of Credit*, in INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW, Vol. IX, *Commercial Transactions and Institutions* § 5-215-16, particularly n. 708. Clearly, however, a penalty clause in an underlying contract (even if it were considered illegal) should not be treated as if it is so harmful as to afford the issuing bank an excuse not to honor its letter of credit.

44. U.C.C. § 5-114(2). See also note 20 *supra*.

colorable claim of fraud. Thus, as in *New York Life Insurance*, the issuing bank will be required to honor its \$8,000,000 commitment to Y.

Once the issuing bank pays Y, can X refuse to reimburse the bank on the ground that the bank violated its contract with X by honoring Y's draft for a penal amount?<sup>45</sup> By contracting with the bank for the issuance of an \$8,000,000 standby letter of credit, X agrees to reimburse the bank if the bank honors drafts which comply with the credit. In this case, the only condition of the credit was that Y present a written notice reciting X's default on the underlying contract. Since such a notice was in fact presented to the bank, the bank correctly honored Y's draft and is entitled to reimbursement from X.<sup>46</sup> Again, even though the amount of the payment constituted a penalty under Contract I, this fact does not affect the bank's right of reimbursement under Contract II.

Subsequent analysis must now consider the position of X and Y in the aftermath of the bank's \$8,000,000 payment to Y and its reimbursement by X. Is there any restitutionary theory by which X can recover from Y the amount by which the payment of \$8,000,000 exceeds reasonable liquidated damages? Since Y suffered only \$1,000,000 in actual damages, let us assume that a reasonably wise forecast of future damages should have approximated this figure. Thus to state the question more precisely, after the bank has paid Y \$8,000,000, is there a restitutionary theory by which X can recover from Y \$7,000,000—i.e., the amount by which the bank's payment exceeded reasonable liquidated damages? The answer to this question requires a detailed analysis of the legal effect of the bank's payment to Y.

The most common form of penalty litigation arises when the nondefaulting party (Y) sues for the enforcement of an *executory* promise to pay stipulated damages made by the defaulting party (X). As has already been mentioned, in this procedural posture, courts will refuse to enforce a stipulated damages clause if the clause constitutes a penalty. But once stipulated damages have been paid, the issue of whether the amount paid constitutes a penalty will be tested in an action brought by the defaulting party (X) against the innocent party (Y) to recover on a *fully performed* promise made by the defaulting party. In essence, once payment has been made pursuant to a standby letter of credit, the action has been transformed from one aimed at enforcing an *executory penalty clause* to one aimed at denying enforcement to a *fully performed forfeiture clause*.<sup>47</sup> In the past, forfeiture problems have

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45. The bank itself would not have a cause of action against Y for a return of the penalty under U.C.C. § 5-111(1). It is true that by presenting his draft, the beneficiary Y warrants to the bank that the necessary conditions of the credit have been complied with. But the only condition of the credit was that Y present to the bank a valid notice of X's default. The default did occur and Y presented the necessary notice. Hence Y has not breached his warranty to the bank.

46. Section 5-114(3) entitles the issuer to immediate reimbursement from the customer when it duly honors a draft or demand for payment. See *International Dairy Queen v. Bank of Wadley*, 407 F. Supp. 1270, 1271 (M.D. Ala. 1976).

47. See Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 495, 517 (1962); C. MCCORMICK, *HANDBOOK ON THE LAW OF DAMAGES* 615 (1935). For a definition of a forfeiture provision, see 5 S. WILLISTON, *supra* note 1, § 769, at 637-41.

commonly arisen in sales transactions where the seller and buyer agree in advance that if the buyer defaults, the innocent seller can keep as liquidated damages all deposits already paid by the buyer.<sup>48</sup> Corbin argues forcefully that forfeiture cases should be handled in the same way as penalty cases. "A penalty will not be enforced merely because it is in the form of a deposit."<sup>49</sup> This is the position adopted in Article 2 of the Code (Section 2-718(2)(a)) with respect to the sale of goods. But when we are outside the scope of Article 2 (as we would be with respect to the construction contract hypothesized in this Article),<sup>50</sup> Corbin's analysis of forfeiture law is somewhat overstated.

As a plaintiff suing to recover a penal forfeiture already paid, X is in a less advantageous position than if he were a defendant in a suit brought to enforce an executory penalty clause.<sup>51</sup> Various impediments either individually or in combination may (a) defeat X's claim outright or (b) at least predispose a judge to find that X and Y's stipulated damages clause constituted reasonable liquidated damages rather than a penalty. For the sake of analysis, these impediments can be divided into three categories—legal impediments, policy impediments, and practical impediments.

## A. Legal Impediments

### 1. Plaintiff in Default

Since the bank has already paid Y \$8,000,000, X will have to sue Y in restitution to recover the excess payment (that is, the \$7,000,000 difference between the amount paid Y and Y's actual damages). But remember, X was the one who deliberately defaulted on the contract, and it is now X who comes to court seeking restitution. Equity may deny relief to a plaintiff who has defaulted on his promise to perform a contract, particularly where that default

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48. See Talbot, *Restitution for the Defaulting Buyer*, 9 CASE W. RES. L. REV. 445 (1958). In the absence of statutory provisions supporting recovery by the buyer, the common law generally denied the buyer recovery of his deposit. *Id.* at 449-52.

49. 5 A. CORBIN, A COMPREHENSIVE TREATISE ON THE WORKING RULES OF CONTRACT LAW § 1074, at 415 (1964).

50. X might possibly argue that his construction contract with Y was a contract within the scope of Article 2 of the Code and therefore sections 2-718(1) and 2-718(2)(a) are applicable to the construction transaction. X would contend that the construction of the plant involves a sale of services (labor) and a sale of goods (cement, etc.) and thus the contract should be governed by Article 2 because of its sale of goods aspect. There are at least two problems with X's argument. First of all, "where the contract is basically one for the rendition of services, and the materials are only incidental to the main purpose of the agreement, the contract is not one for the sale of goods under the U.C.C." *Gulash v. Stylarama, Inc.*, 33 Conn. Supp. 108, 111, 364 A.2d 1221, 1223, 20 U.C.C. Rep. Serv. 603, 605 (C.P. 1975). Construction contracts are generally characterized as services contracts and not as U.C.C. sales contracts. *Id.* at 111, 364 A.2d at 1223-24, 20 U.C.C. Rep. Serv. at 605-06. If the contract had divided the price of construction into the price of labor and the price of materials, X perhaps would have had a stronger argument that Article 2 governed at least the "goods" part of the contract. Second, even if Article 2 applied to the contract, the prohibition against forfeitures in § 2-718(2)(a) deals with breaching buyers, not breaching sellers. In our case, X would be the "seller" and it is he who breached. Thus, X could not directly rely on § 2-718(2)(a). He would have to rely on § 1-106's prohibition against the granting of penal damages "except as . . . provided . . . by other rule of law." As shall be developed below, other rules of law may in fact prevent the recovery of a penal forfeiture in a case where the "seller" and "buyer" create a standby letter of credit.

51. See Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 495, 517 (1962).

has been deliberate and in bad faith.<sup>52</sup> In deciding whether to grant restitution, the judge will have to weigh two competing considerations: on the one hand, plaintiff's unclean hands should deny him recovery, but on the other, penal forfeitures should not be enforced. If he finds the unclean hands doctrine controlling, the judge may deny X's recovery outright, citing to the plaintiff in default rule.<sup>53</sup> Even if a judge decides that the rule against penal forfeitures must prevail, he must still determine whether X and Y's agreement in fact constitutes a penal forfeiture. The line between high but still reasonable liquidated damages and a penalty is a question of judgment.<sup>54</sup> The normal rule requires that the reasonableness of the agreed-upon damages be measured at the time of contracting rather than at the time of breach.<sup>55</sup> Knowing that the plaintiff was the breaching party, a judge might be more prone to find that at the time of contracting \$8,000,000 was a high but reasonable forecast of anticipated losses, even though Y's actual losses later turned out to be only \$1,000,000.

## 2. *Prepayment Versus Executory Promise*

Professor McCormick argues that a court might be more willing to find a pre-paid deposit to be a valid liquidated damages clause than an executory promise to pay the same amount of money.<sup>56</sup> It is easy to act rashly when one promises in advance to pay a certain amount of money. It is more difficult to act rashly when one first has to raise and then actually pay out the money. In such a case, there is time for some sober second thoughts, and consequently the chance of making a grossly excessive payment is reduced.<sup>57</sup> While the standby letter of credit does not involve an actual cash outlay from X to Y, it does require X to negotiate for the issuance of the letter by a bank. The need for this separate contract *with a third party* should serve as a similar brake on rash or disproportionate action. Thus, in deciding whether the payment was a reasonable estimate of probable future losses or a penalty, a judge may be more easily convinced that a payment made pursuant to a negotiated letter of credit was the product of reasoned, as opposed to rash, action.

## 3. *Estoppel*

By initially suggesting the use of a standby letter of credit, X could face an estoppel argument when he tries to recover \$7,000,000 from Y. In the

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52. See, e.g., 1 G. PALMER, *THE LAW OF RESTITUTION* § 5.1, at 572 (1978); Talbot, *Restitution for the Defaulting Buyer*, 9 CASE W. RES. L. REV. 445, 447 (1958).

53. On the plaintiff in default rule, see generally 1 G. PALMER, *THE LAW OF RESTITUTION* ch. 5 (1978). See also Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 495, 516-17 (1962).

54. See 25 C.J.S. *Damages* § 102 (1966).

55. CALAMARI & PERILLO, *supra* note 2, § 14-31, at 566. But see the RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981), which permits the reasonableness of the liquidated damages clause to be measured either at the time of contracting or at the time of breach. See U.C.C. § 2-718(1).

56. MCCORMICK, *supra* note 47, at 615.

57. *Id.*

typical forfeiture case, Y is the party who will demand the prepayment of money as security for X's performance of the contract. Assuming equal bargaining power between X and Y, X may want to win the contract, but he may not have the cash to make the security payment. X may then suggest the use of a standby letter of credit as an alternative to the security deposit.<sup>58</sup> If Y agrees to forego the security deposit, accepting the bank's letter instead, X will be benefited because he will not have to raise and pay the money immediately. In fact, X will probably not sign a contract if he envisions defaulting on it, so X will assume that by using a standby letter, he will never have to pay the money. Since the choice of the standby letter was X's, and since Y relied on the letter for his security, X will be in a difficult position to object when his chosen device has been implemented.<sup>59</sup> Even if this argument may not be sufficiently strong to defeat X's claim outright, it will be at least a consideration militating against his recovery.

#### 4. *Lack of a Precise Restitutionary Theory Supporting Recovery*

As has already been mentioned, to recover the excess payment made to Y, X will have to sue Y in restitution.<sup>60</sup> The controlling principle of the law of restitution is unjust enrichment.<sup>61</sup> But unjust enrichment is itself not an "operative rule" but "a principle which underlies many particular rules."<sup>62</sup> These particular restitutionary rules, however, do not support X's recovery from Y—in fact certain of these rules, by analogy, would deny X any recovery.

##### a. *Mistake*

Restitution will support the recovery of amounts paid by mistake.<sup>63</sup> Mistakes can be of two kinds—of fact or of law.<sup>64</sup> As for a mistake of fact, since both X and Y voluntarily stipulated the amount of the penalty, X could hardly argue that there was either a mutual or a unilateral mistake of fact with respect to the amount agreed upon. It would be equally difficult for X to claim that the payment resulted from a mistake of law. In our hypothetical transaction, the standby letter of credit obligated the bank to pay \$8,000,000 on condition that Y present the bank with his draft and a written notice attesting to X's default on the contract. Since Y complied with the condition, the bank had

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58. In *New York Life Ins. Co. v. Hartford Nat'l Bank & Trust Co.*, 173 Conn. 492, 378 A.2d 562, 22 U.C.C. Rep. Serv. 761 (1977), the customer, not the beneficiary, seemed to suggest the use of a standby letter of credit in lieu of a cash deposit.

59. Technically, X's prior conduct in choosing the use of the standby letter and Y's reliance on that prior conduct would constitute an equitable estoppel. See 30 C.J.S. *Equity* §§ 107, 108 (1965).

60. At common law, an action to secure restitution, since it was based on quasi-contract, was usually considered an action at law. Sometimes, however, restitution could be sought in equity. See *RESTATEMENT OF RESTITUTION*, Part I, Introductory Note at 4-5 (1937).

61. *Id.* § 1 and Comment c (1937).

62. *CALAMARI & PERILLO*, *supra* note 2, § 15-2, at 571.

63. *RESTATEMENT OF RESTITUTION*, ch. 2, Introductory Note, at 26 (1937).

64. *Id.*

to pay regardless of whether the amount constituted a penalty. Thus the payment from bank to Y did not result from a mistake of law. But even if it did, not every payment based on a mistake of law is automatically recoverable. The Restatement of Restitution states that one "who, induced thereto solely by a mistake of law, has conferred a benefit upon another to satisfy . . . an honest claim of the other to the performance given, is not entitled to restitution."<sup>65</sup> By presenting his draft to the bank for \$8,000,000, Y presumably has made an honest claim for the money. The Restatement defines an honest claim broadly: "The transferee [here Y] makes an honest claim if he believes, however unreasonably, that the performance rendered by the other is due him, or that there is a chance that it is due."<sup>66</sup> For the reasons developed in the prior and subsequent analysis, Y could honestly believe that there was at least a chance that the \$8,000,000 was due him. Hence X could not utilize mistake as the basis of his restitution action.

#### b. *Fraud or Duress*

Payments received through fraud or duress would also support restitutionary recovery by X.<sup>67</sup> In the hypothetical presented, however, we have assumed the absence of these factors. It has been assumed that both X and Y had other options and chose to contract voluntarily and out of perceived self-interest. In addition, both X and Y are large businesses and presumably advised by competent and sophisticated counsel. Thus, with respect to the stipulated damages clause (\$8,000,000), there would be little chance that X was either coerced or defrauded—the final agreement as to the amount represented a considered decision by both contracting parties.

#### c. *Illegality*

X might argue that a penalty clause in a contract is illegal and thus any enforcement of such a clause, whether direct or indirect, would be contrary to public policy. To permit the forfeiture of the full amount paid to Y would be to enforce indirectly a penalty and thus violate public policy. X's argument, however, is flawed for two reasons. First, the rule prohibiting the enforcement of penalty clauses and penal forfeitures evolved from the law of unconscionability, not from the law of illegality.<sup>68</sup> Therefore, to claim that penal forfeitures are unenforceable because they are illegal may not be totally accurate. Second, even if one were to accept *arguendo* X's characterization, X would still be unable to recover in restitution—at least according to the general rule. Normally, when one party has already made an illegal payment, the law will leave both parties in the same position as it finds them.<sup>69</sup> This rule, of course,

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65. *Id.* § 45. The exceptions to this rule do not seem applicable to the facts presented in this Article.

66. *Id.* § 45, comment b.

67. For restitution for fraud, see *id.* § 28 and comment a; for duress, see *id.* § 70.

68. CALAMARI & PERILLO, *supra* note 2, § 9-38, at 318-19.

69. *Id.* § 22-5, at 785.

does admit of some exceptions. One common exception permits the return of the illegal payment if the plaintiff can demonstrate that, as between him and the defendant, he is not "in pari delicto," that is, he is the less culpable party.<sup>70</sup> This exception, however, could hardly justify returning the \$7,000,000 to X. Assuming Y did not coerce or defraud X, why should X be considered less culpable in agreeing to the clause than Y?

#### d. *Penalty Theory*

Those cases that permit the recovery of penal forfeitures generally do so on the theory that penal forfeitures are analogous to penalty clauses.<sup>71</sup> But as has already been shown, the analogy between executory penalty clauses and penal forfeitures is not totally persuasive.<sup>72</sup> Plaintiff's unclean hands are relevant in the forfeiture case but not relevant in the penalty case. Since forfeiture cases do involve this added relevant factor, they hardly seem directly analogous to penalty cases.

Thus, for X to recover in restitution, he will have to argue that unjust enrichment is a general principle permitting recovery in all such situations rather than a set of discrete rules permitting recovery in only some situations. While this is not an unreasonable position, our legal system has not yet accepted it.<sup>73</sup>

#### B. *Policy Impediments*

Even when impediments such as the plaintiff in default rule are present, they should not necessarily be controlling if a strong countervailing policy exists favoring X's recovery. The stronger the countervailing policy, the more reason to neutralize competing factors. Subsequent analysis will show, however, that the policy against penal forfeitures is not as strong as it might first appear. First, in some areas of the law, there is a respectable body of case law that has enforced penal forfeitures with little discussion. Second, contract law may even permit a more generalized enforcement of forfeitures and penalty clauses if the contracting parties structure their transaction in a certain way. Third, when a transaction contains a standby letter of credit, the presence of the letter provides an *affirmative* justification for enforcing a penal forfeiture.

##### 1. *The Policy Against Penal Forfeitures Is Not Universally Applied*

Case law in the United States, almost without exception, denies enforcement to executory penalty clauses.<sup>74</sup> But there does not seem to be a similar

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70. *Id.* § 22-12, at 794.

71. *See, e.g.,* Davy v. Crawford, 147 F.2d 574 (D.C. Cir. 1945); Oldden v. Tonto Realty Corp., 143 F.2d 916 (2d Cir. 1944).

72. *See* text accompanying notes 51-55 *supra*.

73. *See* note 62 *supra*.

74. *See* note 1 *supra*.

general consensus with respect to the enforcement of penal forfeitures. In certain types of cases, judges have routinely refused to return prepaid deposits without regard to the amount of these deposits. For example, in mortgage finance contracts, courts have consistently sustained the validity of standby deposit provisions even though the amount of the deposit may have exceeded a reasonable estimate of future losses.<sup>75</sup> In land sales contracts, judges often deny a defaulting vendee the return of his deposit paid to the innocent vendor of the land,<sup>76</sup> although one would have assumed that courts would permit the vendee to recover his deposit if it exceeded the vendor's damages. Similarly, in cases involving prepaid bids on public contracts, courts generally deny the defaulting bidder the return of his bid.<sup>77</sup> There was even a time, before changes made by Article 2 of the U.C.C.,<sup>78</sup> when courts frequently refused a defaulting buyer the return of his deposit in sales of goods cases.<sup>79</sup> There is therefore a respectable body of case law that permits the enforcement of penal forfeitures.

## 2. *The Policy Against Penal Forfeitures May Permit a Dodge— At Least in Part*

The relative importance of any policy, or for that matter the relative importance of any rule of law, can be tested by the ease with which it can be successfully avoided. The more significant the policy, the more difficult it should be to find successful dodges around it. Application of this test suggests that the policy against enforcing penalties and penal forfeitures may not be as strong as it initially appears. Although commentators may strongly dispute this conclusion, the law of alternative promises<sup>80</sup> seems to provide an acceptable dodge around the strictures of penalty and forfeiture law.<sup>81</sup>

In our hypothetical, X promised to construct a plant and Y promised to pay X \$35,000,000 for the construction. Thus, X's primary promise was conceived to be the building of the plant. In addition, however, X made a secondary promise—to pay \$8,000,000 as security against defaulting on his primary promise. Classic contract theory will not enforce a secondary promise to pay any amount above compensatory damages. Thus the penalty promise is rendered unenforceable. But might contract law enforce X's promise to pay

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75. See *Shel-Al Corp. v. American Nat'l Ins. Co.*, 492 F.2d 87, 95 (5th Cir. 1974).

76. C. MCCORMICK, *supra* note 47, at 615-16.

77. See Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 495, 517 n.76 (1962).

78. U.C.C. §§ 2-718(1), 2-718(2)(a).

79. See 1 G. PALMER, *THE LAW OF RESTITUTION* § 5.11, at 635-36 (1978).

80. For a discussion of the law of alternative promises, see CALAMARI & PERILLO, *supra* note 2, § 14-34, at 568; 5 A. CORBIN, *supra* note 49, §§ 1079 and 1082; C. MCCORMICK, *supra* note 47, § 154 at 617-18; 5 S. WILLISTON, *supra* note 1, § 781, at 704-09, and § 782, at 714-19.

81. Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 495, 500 (1962), seems to agree with this conclusion that an alternative promise can sometimes enforce a penalty. Occasionally, cases suggest that the law of alternative promises does constitute a dodge around penalty law. See, e.g., *Paolilli v. Piscitelli*, 45 R.I. 354, 358, 121 A. 531, 533 (1923). See also *Hasbrouck v. Van Winkle*, 261 A.D. 679, 682, 27 N.Y.S.2d 72, 76 (3d Dep't 1941), *aff'd per curiam*, 289 N.Y. 595, 43 N.E.2d 723 (1942), which suggests that alternative contracts can approach very near to a stipulation for a penalty.



\$8,000,000 if it were structured differently? What if Y promised to pay X \$35,000,000 to build the plant, and X made two primary promises in the alternative—i.e., either to build the plant or not to build the plant and pay \$8,000,000? Would the law of alternative promises enforce X's alternative promise to pay if he chose not to build the plant? Williston would say "no"—this form of contract cannot be used as "a vehicle for the enforcement of a penalty."<sup>82</sup> Williston would look at the reasonableness of each of the alternative promises. Unless both of the alternatives—to build or not to build and pay \$8,000,000—could be considered reasonable options for X, the law should treat the contract as a disguised penalty.<sup>83</sup> For Williston, since X could simply breach his contract with Y and pay Y compensatory damages of \$1,000,000, it would never be reasonable for X to choose to pay the penalty. Hence, a true case of alternative promises does not exist. McCormick takes the same position:

[W]hile an alternative promise to pay money when it presents a conceivable choice is valid, yet, if a contract is made by which a party engages himself either to do a certain act or to pay some amount which at the time of the contract no one would have considered an eligible alternative, the alternative promise to pay is unenforceable as a penalty.<sup>84</sup>

But despite the conclusions of such eminent authorities, the law of alternative promises might in some situations provide a mechanism for enforcing what otherwise would appear to be a penalty. The law of alternative promises is posited on whether the parties actually bargained to create reasonable alternatives.<sup>85</sup> The law of penalties is posited on whether there was a reasonable forecast of Y's future losses.<sup>86</sup> The two rules are not the same. It is possible for X and Y to set the estimate of Y's future losses unreasonably high (a penalty) but still have the payment of that same amount of money be a reasonable option for X. Let us suppose that at the time of contracting X is a well-known builder whose services normally demand a premium. X realizes that if he defaults, Y can easily obtain a substitute performance from V for less money than he agreed to pay X. If the stipulated damages clause of \$8,000,000 is tested by whether or not the amount constitutes a reasonable estimate of Y's future losses, it would be ruled a penalty. But if that same stipulated damages clause is tested by whether X could have reasonably agreed to the clause, we may find that X's agreement was quite reasonable. X may realize that because of his reputation, A may later offer him a substantial premium for his services. Under the circumstances, it may be reasonable for X to agree to the \$8,000,000 payment. Because X's reputation commands such a premium, Y might be able to obtain specific performance of their

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82. 5 S. WILLISTON, *supra* note 1, § 782, at 715.

83. *Id.* § 781, at 708.

84. C. MCCORMICK, *supra* note 47, § 154, at 618. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 356, comment c.

85. CALAMARI & PERILLO, *supra* note 2, § 14-34, at 568.

86. *Id.* § 14-31, at 565.

contract, thereby preventing X from taking the more lucrative contract. Recently, courts have been more liberal in granting specific performance in construction contracts.<sup>87</sup> Consequently, X may be willing to pay \$8,000,000 to forestall possible specific performance and maintain an option to buy his way out of the contract with Y.<sup>88</sup> Viewed in this way, what first appeared a penalty now appears a reasonable, and in fact a potentially valuable, option for X.

Thus the law of alternative promises permits the reasonability of the promise to be judged from all surrounding circumstances, not just from the perspective of Y's future losses. Hence, in many instances, particularly when there is a possibility of specific performance, it should be easier to defend a large stipulated payment when it is structured as an option price rather than as a liquidated damages clause. This is not to say, however, that in all cases a high option price will be defensible. But at least when it is structured as a reasonable alternative promise, the court will be able to focus on the full bargain of the parties (as evidenced by the totality of circumstances surrounding the contract) rather than on the reasonability of their estimate of Y's future losses.<sup>89</sup>

### 3. *The Policy Supporting Forfeiture Enforcement—The Presence of a Standby Letter of Credit*

When a standby letter of credit is used in a transaction to effect a penal forfeiture, it usually bespeaks the presence of two things: sophisticated businessmen and added transaction costs.

#### a. *The Sophisticated Businessman*

A rigid rule that refuses to enforce penalties and penal forfeitures may be justified in consumer transactions where the possibilities of unconscionability are many and subtle. Such a rule, however, is less justifiable in business transactions entered into by large corporations advised by sophisticated corporate counsel. If there is no coercion or unconscionability, why shouldn't two large corporations be able to include a penalty or a penal forfeiture in their contract and have the law enforce it? In our hypothetical, X and Y built the forfeiture around a standby letter of credit. These letters are not customarily used in the ordinary consumer transaction; they are sophisticated devices used by sophisticated counsel and businessmen to achieve certain results. In

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87. See cases collected in Linzer, *On the Amorality of Contract Remedies—Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111, 126 n.101 (1981).

88. See Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 283 (1979). Schwartz argues that a promisor in a unique goods market (arguably X who commands a premium because of his reputation) will usually have a "strong incentive to preserve his freedom to breach." *Id.*

89. The Restatement (First) of Contracts gave at least some indirect support to the notion that alternative promises can constitute dodges around penalty law. The Restatement admitted that alternative promises were enforceable and that they were easily confused with unenforceable penalties. The confusion mirrored their similarity. RESTATEMENT (FIRST) OF CONTRACTS § 344 comment c and § 339 comment f (1932). Corbin also recognized possible confusion between the two. 5 A. CORBIN, *supra* note 49, § 1082, at 463-64.

*Shel-Al Corp. v. American National Insurance Co.*,<sup>90</sup> plaintiff sued to recover an amount paid pursuant to a standby letter of credit, claiming that this amount plus a separate cash deposit together constituted a penalty. In rejecting plaintiff's claim, the Fifth Circuit emphasized that plaintiff had been advised by counsel<sup>91</sup> and that standby deposits were "thoroughly lawful" methods of doing business in the world of real estate mortgage financing.<sup>92</sup> A per se rule against penal forfeitures would needlessly limit freedom of contract in an area where there is little reason to apply protective policies.

#### b. *Added Transaction Costs*

Standby letters of credit increase both the pre-breach and the post-breach transaction costs of any deal. For example, even when there has been no breach of the underlying contract by X, the very presence of a standby letter entails added costs. X and Y must first negotiate the terms of the letter; X must then negotiate with a bank for the issuance of the letter and pay the bank its fee. Of course, if X defaults on the underlying contract, the presence of the standby letter increases post-breach transaction costs as well. Y will demand payment of the letter; the bank will pay and in turn demand reimbursement from X. X will have to raise the money or negotiate a loan with the bank. All these events increase the transaction costs required by the presence of the standby letter. Thus, when the parties decide to increase these costs to achieve a particular result (that is, to guarantee payment of a penalty), it usually indicates that the parties really want the result. Hence, the greater the costs expended, the clearer the intent of the parties, and the less reason to vitiate their efforts.

#### C. *Practical Impediments*

"Possession is nine points of the law." If the truth of this old adage was ever in doubt, one only need review recent standby letter of credit litigation. Once the bank has honored the beneficiary's draft, practical realities often make it difficult, and sometimes impossible, for the bank's customer to recover any of the money paid.<sup>93</sup> The practical problems differ depending on whether an international or a domestic standby letter is involved in the transaction.

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90. 494 F.2d 87 (5th Cir. 1974).

91. *Id.* at 89.

92. *Id.* at 95.

93. Note the complex standby letter of credit litigation arising out of the 1979 revolution in Iran. See, e.g., *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10 (2d Cir. 1979); *American Bell Int'l, Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420 (S.D.N.Y. 1979). More than twenty other organizations sued to enjoin banks from honoring their payment commitments. See Note, "Fraud in the Transaction": *Enjoining Letters of Credit During the Iranian Revolution*, 93 HARV. L. REV. 992, 994 (1980). Companies realized that once payments were made pursuant to the letters, it would be practically impossible to recover the money from Iran. Hence it is understandable why companies sought to enjoin banks from paying drafts under their letters of credit. See Gable, *Standby Letters of Credit: Nomenclature Has Confounded Analysis*, 12 LAW & POL'Y INT'L BUS. 903, 939-41 (1980).

### 1. *International Standby Letters of Credit*

The most serious practical difficulties have appeared in international standby letter of credit cases. In recent years, many international business deals have employed the standby letter of credit.<sup>94</sup> The certainty of payment that these letters represent makes them particularly attractive to businessmen dealing at great distances with individuals and corporations of unknown solvency and business reputation. For the sake of analysis, let us assume that in our hypothetical, Y, instead of being an American corporation, is an Iranian corporation. Assume also that construction of the plant was to be in Teheran. If the contract between X and Y is a typical international construction agreement, it may contain a forum selection clause (all disputes with respect to this contract are to be heard in a competent Iranian court) and/or a choice of law clause (this contract is to be governed by the law of Iran).<sup>95</sup> If X defaults on the contract and Y is paid \$8,000,000 pursuant to the standby letter of credit, each of these clauses can present X with a difficult set of problems in trying to recover from Y.

#### a. *Forum Selection Clause*

Once the letter is paid, a forum selection clause forces X to seek recovery of the excess payment in an Iranian court. The political situation in a particular foreign country at any given time may make recovery unlikely or virtually impossible. Even if an American court could be persuaded not to enforce the forum selection clause,<sup>96</sup> any judgment against Y in an American court would be only symbolic, unless Y had assets either in the United States or in some

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94. By 1978, commercial banks in the United States had issued approximately \$25 billion worth of standby letters of credit. Gable, *Standby Letter of Credit: Nomenclature Has Confounded Analysis*, 12 LAW & POL'Y INT'L BUS. 903, 913 n.50 (1980). With respect to the government of Iran alone, American contractors were "contingently liable for millions of dollars in guarantee letters of credit . . ." Note, "Fraud in the Transaction": *Enjoining Letters of Credit During the Iranian Revolution*, 93 HARV. L. REV. 992, 992 (1980). See also Arnold and Bransilver, *The Standby Letter of Credit—The Controversy Continues*, 10 U.C.C. L.J. 272, 278-79 (1978).

95. The underlying contract (Contract I) in *American Bell Int'l, Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420, 421 (S.D.N.Y. 1979), contained both of these clauses. A choice of law clause alone was present in the underlying contract (Contract I) in *Dynamics Corp. v. Citizens & Southern Nat'l Bank*, 356 F. Supp. 991, 993, 12 U.C.C. Rep. Serv. 317, 319 (N.D. Ga. 1973). "Forum selection clauses" in underlying contracts between American companies and the Government of Iran caused particular problems in arranging for the release of the American hostages held in Teheran during 1981. If such a clause existed, American companies were precluded from presenting their claims to the International Arbitral Tribunal organized to settle claims between the United States and Iran. See *Settlement of Claims Agreement*, Jan. 19, 1981, Art. II, 20 INT'L LEGAL MATERIALS 224, 230-31 (1981). On the entire subject of the Iran-United States Hostage Agreement, see McLaughlin and Teclaff, *The Iranian Hostage Agreements: A Legal Analysis*, 4 FORDHAM INT'L L.J. 223 (1981).

96. In *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972), the Supreme Court recognized that a freely negotiated international forum selection clause requiring suit in a neutral foreign jurisdiction should be enforced unless one of the parties to the contract could demonstrate that enforcement would be "unreasonable and unjust." *Id.* at 15. A clause selecting Iran as the forum could be distinguished from the facts in *The Bremen* since it would not be a neutral forum. Similarly, the American company could show that the political climate in Iran would make enforcement of the clause "unjust." See *American Bell Int'l v. Islamic Republic of Iran*, 474 F. Supp. 420, 423 (S.D.N.Y. 1979); Gable, *Standby Letters of Credit: Nomenclature Has Confounded Analysis*, 12 LAW & POL'Y INT'L BUS. 903, 937 n.182 (1980).

other non-Iranian jurisdiction that would enforce the American judgment.<sup>97</sup> X, of course, may have foreseen these problems at an early stage and tried to keep some of Y's assets in the United States as security for the payment of any eventual judgment. Litigants have tried to attach the bank's payment under the letter of credit as a way of keeping assets of the beneficiary in the jurisdiction.<sup>98</sup> Such attempts have been universally unsuccessful.<sup>99</sup> Apart from the constitutional issues involved,<sup>100</sup> if these attachments were successful, they would undermine the central principle of letter of credit law—certainty of the issuing bank's payment obligation.<sup>101</sup>

### b. *Choice of Law Clause*

If the contract between X and Y contained not a forum selection clause but a choice of law clause, different practical and legal problems would emerge. The law of many foreign countries may countenance the enforcement of penalties and penal forfeitures.<sup>102</sup> Thus, even if a suit could be instituted in a particular foreign country, the courts of that country might deny X relief. If suit were instituted instead in an American tribunal, the American court might choose to enforce the choice of law clause, thus applying the foreign law.<sup>103</sup> Again X would be denied relief. Even if the foreign law stipulated in the contract would not enforce penalties, exchange controls, expenses of travel to the forum, and increased counsel and expert witness fees might reduce substantially the value of X's recovery.

## 2. *Domestic Standby Letters of Credit*

Compared to the international letter, the domestic standby letter of credit presents a different set of practical problems for X. A domestic standby letter can increase X's litigation costs and postpone the time of X's eventual recovery, thus reducing the real dollar value of that recovery. Consider the two examples that follow.

97. If, as in the case posited, the defendant were a foreign government, a suit in an American court would raise issues with respect to the Foreign Sovereign Immunity Act, 28 U.S.C. §§ 1602-1611 (1976). See Note, "Fraud in the Transaction": *Enjoining Letters of Credit During the Iranian Revolution*, 93 HARV. L. REV. 992, 994 n.10 (1980).

98. See, e.g., *Lantz Int'l Corp. v. Industrial Termotecnica Campana, S.p.A.*, 358 F. Supp. 510 (E.D. Pa. 1973).

99. See Justice, *Letters of Credit: Expectations and Frustrations—Part 2*, 94 BANKING L.J. 493, 495 (1977).

100. See *Shaffer v. Heitner*, 433 U.S. 186 (1977).

101. See J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 18-10, at 752-53 (2d ed. 1980).

102. In civil-law countries, for example, penalty clauses are in principle valid. See Report of the Secretary-General: liquidated damages and penalty clauses, [1979] 10 Y.B. COMM'N INT'L TRADE LAW 40, U.N. Doc. A/CN.9/161 para. 16. In the United States, Louisiana enforces penalty clauses, *Pembroke v. Gulf Oil Corp.*, 454 F.2d 606 (5th Cir. 1971).

103. Choice of law clauses that stipulate the application of foreign law are normally enforced by American courts. *Siegelman v. Cunard White Star Ltd.*, 221 F.2d 189, 193-95 (2d Cir. 1955).

First, X may not be able to acquire personal jurisdiction over Y in his home state simply because a bank in X's home state issued the standby letter of credit in Y's favor. The mere issuance of the letter may not be a sufficient predicate of jurisdiction over Y unless, of course, Y has other forum contacts.<sup>104</sup> Therefore X may have to sue Y outside his home state, a necessity that may add substantially to X's travel and litigation costs.

Second, since Y now is in possession of the money, it will be to Y's advantage to draw out the litigation for as long as possible. Even if Y may eventually lose, he will only have to return the \$7,000,000 with interest at the judgment rate.<sup>105</sup> In the meantime, Y can invest the \$7,000,000 and receive a higher interest rate than he will have to pay X. Thus Y can increase his litigation costs and still make a profit while X will not be able to recoup his added litigation expenses.<sup>106</sup> Of course, if X can show that Y acted in bad faith in unnecessarily drawing out the legal process, X may be able to shift some of his expenses to Y.<sup>107</sup> But it is unlikely that X will be able to marshal enough proof to make out a sufficient case of bad faith.

Thus, by transforming an executory penalty clause into a fully executed penal forfeiture, standby letters of credit may as a practical matter result in the enforcement of penalties.

The student of letter of credit law, however, may bridle at this conclusion on theoretical grounds. If the underlying contract (Contract I) cannot affect the letter of credit contract (Contract III), how can the letter of credit contract effect so drastic a change in the respective rights of the parties to the underlying contract? There seems to be no policy objection to this one directional flow, however. The fundamental policy furthered by letters of credit is certainty of payment. Therefore, disputes relating to Contract I cannot affect the letter of credit commitment (Contract III) without undermining this policy. But the reverse is not true. Once the certainty of payment embodied in Contract III is preserved, there is no reason to prevent Contract III from affecting rights in Contract I.

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104. After all, X (the customer) presumably selected the issuing bank. The fact that the issuing bank was in X's state was for the convenience and accommodation of X. Unless Y directed X to choose a particular issuing bank in X's state, X's discretionary acts in choosing the issuer should not provide a basis for personal jurisdiction over Y. In *Thomas J. Palmer Inc. v. Turkiye is Bankasi*, 105 Cal. App. 3d 135, 164 Ca. Rptr. 181 (1980), the California court found that the beneficiary of a standby letter was not amenable to jurisdiction in California. On related jurisdictional points see *Werner Lehara Int'l, Inc. v. Harris Trust & Sav. Bank*, 484 F. Supp. 65 (W.D. Mich. 1980); *Texas Trading & Milling Corp. v. Federal Republic of Nigeria*, 500 F. Supp. 320, 325-26 (S.D.N.Y. 1980), *rev'd*, 647 F.2d 300 (2d Cir. 1981).

105. In New York, for example, the judgment rate of interest was raised from 6% to 9%. N.Y. LAW § 5004 (McKinney 1981). In most situations New York does not permit compounding the judgment interest. D. SIEGEL, HANDBOOK ON NEW YORK PRACTICE 547 (1978).

106. See *Bankers Trust Co. v. Publiker Indus., Inc.* 641 F.2d 1361, 1367-68 (2d Cir. 1981), for a discussion of the effect of the low judgment interest rate on the appeal process.

107. "In the United States, the prevailing litigant is ordinarily not entitled to collect a reasonable attorneys' fee from the loser." *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 247 (1975). If the prevailing party, however, can demonstrate that the other side acted in bad faith, the court could require the losing party to pay the attorneys' fees of the prevailing party. *Id.* at 258-59.

Although this conclusion that standby letters of credit can enforce penalty clauses may be justified on equitable and practical grounds, it remains to be seen whether this conclusion can be justified on economic grounds.

#### IV. ECONOMIC ANALYSIS OF THE STANDBY LETTER TRANSACTION

Orthodox economic thinking argues that if X can get a better deal from A than from Y, he should be encouraged to default on his contract with Y and take the better deal from A.<sup>108</sup> As long as X compensates Y for the added expense of any substituted performance, society as a whole will be benefited by X's breach. Y gets his performance and X gets the added economic benefit of a more lucrative contract. Limited resources are better allocated by this arrangement.

The enforcement of penalties appears to contradict this theory of the so-called efficient breach. Goetz and Scott, however, have questioned these assumptions and demonstrated that the enforcement of penalties (assuming no unconscionability or duress) does not violate the theory of efficient breach.<sup>109</sup> To oversimplify their analysis: assume X agreed to build the plant for Y for \$35,000,000 and to pay \$8,000,000 as a penalty if he defaulted. A now offers X \$40,000,000 to build a different plant. If the penalty were enforced, X would not breach his contract with Y because he would lose \$8,000,000 and gain only \$5,000,000 from A—a net loss of \$3,000,000. But Goetz and Scott argue that in this situation, X will not default but instead negotiate out from under the penalty—i.e., X will buy a release from Y by offering to pay Y his damages (\$1,000,000—the cost of a substitute performance from V) and in addition part of his profit from the contract with A.<sup>110</sup> Since X will receive \$5,000,000 more from A than from Y, he can easily pay Y \$1,000,000 to buy the release. Assuming Y acts rationally, Y should accept the offer—he will have his plant and a \$1,000,000 bonus. X will also be better off by \$3,000,000. If Y either refuses to give X a release or demands too high a price for the release, X can always forego the contract with A and perform for Y. Therefore, in a legal regime that enforces penalties, the mutual self-interest of X and Y should always work to prevent the enforcement of penalties. The market place will lead the contracting parties to strike a mutually advantageous deal.

Would Goetz and Scott's marketplace analysis hold true in our standby letter of credit transaction? It should, if both X and Y act to maximize their self-interest. Once X sees a better contract in the offing, he will approach Y to buy a release, offering Y his damages and a bonus. The critical question is whether the existence of the independent contracts between X and the bank and between the bank and Y can somehow work to block the deal. Obviously an agreement between X and Y to release X on the underlying contract

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108. See note 6 *supra*.

109. See Goetz and Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977).

110. *Id.* at 566-68.

(Contract I) cannot affect the bank's obligation to Y on the letter of credit (Contract III) and the bank's obligation to X pursuant to their agreement (Contract II). In fact, in *AMF Head Sports Wear, Inc. v. Ray Scott's All-American Sports Club, Inc.*,<sup>111</sup> the court held that even when requested by both customer and beneficiary, the issuer has no duty to amend a letter of credit. But assuming that the bank, the customer, and the beneficiary all agree, nothing in letter of credit law would prevent the standby letter from being either modified or canceled to permit X to buy a release from Y.<sup>112</sup>

Section 5-106(2) of the U.C.C. states that "unless otherwise agreed once an irrevocable credit is established as regards the customer it can be modified or revoked only with the consent of the customer and once it is established as regards the beneficiary it can be modified or revoked only with his consent."<sup>113</sup> Since the bank's irrevocable commitment to pay \$8,000,000 has been established as regards beneficiary Y by Y's receipt of the letter, Y can agree with the bank to revoke the letter of credit and thereby relieve the bank of its liability to Y under Contract III. The bank's obligation to pay the letter for the benefit of its customer, X, was established with respect to X by the bank's sending of the letter to Y. X and the bank, however, can also agree to revoke the letter, thereby relieving the bank of its contractual and good faith obligations to X under Contract II. Although X and Y together cannot force the bank to cancel its obligations to each, the bank should have no reason to object to the cancellation when both parties request it. The bank will undoubtedly wish to please its customer and the cancellation of the letter should not affect the bank's fee for originally issuing the letter. In fact, under the circumstances, by agreeing to cancel the letter, the bank may assure itself of additional business. More than likely a second modified standby letter will be issued in lieu of the first. Since X has agreed to pay Y \$1,000,000 in damages and \$1,000,000 as an added bonus for releasing him from the underlying contract, Y will wish the bank to issue a new standby letter to guarantee payment of these amounts. All parties should be content with the new arrangement. Y will be content because he will receive his plant and the \$1,000,000 bonus guaranteed by the modified letter. X will be content because he will receive \$3,000,000 more by performing for A than for Y. The bank will be content because it will undoubtedly receive an additional fee for the issuance of the second modified letter.<sup>114</sup> Therefore, nothing in standby letter of

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111. 448 F. Supp. 222, 23 U.C.C. Rep. Serv. 990 (D. Ariz. 1978).

112. See, e.g., *It's Devine Indus. Ltd. v. Bank Leumi Trust Co.*, 22 U.C.C. Rep. Serv. 130 (N.Y. Sup. Ct. 1977).

113. U.C.C. § 5-106(2). The Uniform Customs and Practice for Commercial Documentary Credits, *supra* note 11, adopts a similar position. Article 3(c) states that an irrevocable letter of credit "can neither be amended nor cancelled without agreement of all parties thereto."

114. U.C.C. § 5-105 states that "[n]o consideration is necessary to establish a credit or to enlarge or otherwise modify its terms." Although this section does not require consideration, the issuing bank will charge a fee for the issuance of a standby letter of credit. See Official Comment to U.C.C. § 5-105. If the bank agrees to modify the letter, the original letter will be recalled and a new, modified letter issued. Undoubtedly, the bank will negotiate to be paid an extra fee for its administrative expenses.



credit law prevents Goetz and Scott's marketplace analysis of penalty clauses from working to permit X to buy a release from Y.

This conclusion (that economic efficiency will not suffer in a legal regime in which standby letters of credit act to enforce penalties) can be probed more deeply, however. Goetz and Scott were correct in demonstrating that a rule that refuses to enforce penalties produces no more social gain than a rule that enforces penalties. Under the "non-enforcement" rule (let us call it Rule I), all of the social gain goes to the breaching party X. When A approaches X with the more lucrative offer, X will accept it, make a profit of \$5,000,000 and pay Y \$1,000,000 in damages. X thus keeps the whole profit of \$4,000,000. Under the "enforcement" rule (Rule II), the gain is shared between X and Y. When A approaches X with the more lucrative offer, X will have to buy a release from Y, paying Y his damages and a share of his \$4,000,000 profit. Depending on the price agreed to, X will keep perhaps \$3,000,000 of the gain and Y will receive \$1,000,000 of the gain. The only difference between Rule I and Rule II is not in the amount of social gain created, but in how that gain is divided.<sup>115</sup>

If one assumes then that both rules produce equal social gain, it does not follow that both rules are equally "cheap" to operate. To produce \$4,000,000 of social gain, each rule requires X and Y to incur different transaction costs. Since these transaction costs do not create new social gain but simply distribute existing gain, they represent what economists call a "'dead-weight' efficiency loss."<sup>116</sup> Again, if both rules produce an equal amount of social gain, the preferred rule should be the one that results in the fewest transaction costs.

Under Rule I (the non-enforcement rule), X and Y would first have to incur the costs necessary to negotiate both the penalty clause and the standby letter of credit. When X defaults to perform for A, other costs would be incurred, depending on X and Y's negotiating strategies. X will undoubtedly offer to pay Y the cost of a substituted performance in order to avoid litigation. For various reasons, however, Y will probably refuse the offer. First, Y will realize that he may be able to recover more in damages than the difference between his substituted performance and the contract price. He may be able to recover certain consequential damages and damages caused by the delay in obtaining a substituted performance. Second, Y will realize that, because X has defaulted, the bank will have to honor its letter of credit and pay Y his draft. Thus, if there is litigation after the bank pays, Y will be in possession of the \$8,000,000 penalty during the course of the trial. Pending judgment, he can invest the disputed sum at a high market rate of interest and profit on the difference between the market rate and the judgment rate. Therefore, under Rule I, Y has little incentive to agree to a quick out-of-court

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115. See Goetz and Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 567-68 (1977).

116. Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 285 (1979).

settlement. Hence, Y will undoubtedly present his draft and notice of default to the bank and await future developments. At this point, of course, the bank will incur transaction costs in comparing Y's notice of default with the standby letter. These costs, however, should be minimal. But once the bank does honor Y's draft, X must immediately reimburse the bank for the \$8,000,000 payment. To make the payment, X will have to either liquidate assets or procure a secured or unsecured loan from the bank. This could result in substantial transaction costs for X. After reimbursing the bank, X must institute suit against Y to recover the penalty. Although the damages rule to be applied appears clear—X should recover the difference between the \$8,000,000 payment and Y's actual losses—it may still be difficult to calculate Y's losses. As has been mentioned earlier, Y will claim damages beyond the cost of substituted performance over contract price. The resolution of Y's added damage claims will increase transaction costs. Under Rule I, X should eventually prevail in the litigation, but Y has a definite incentive to prolong it.

Under Rule II, which enforces penalties, X and Y should incur initial costs comparable to those incurred under Rule I, that is, the costs necessary to negotiate both the penalty clause and the standby letter of credit. When X approaches Y for a release, both parties will incur transaction costs negotiating an acceptable agreement. Unlike damages rules in litigation, there are no definite rules for the shape of an acceptable agreement, so these negotiations could be difficult.<sup>117</sup> Y will try to extort a handsome price for the release, and X will try to buy the release cheaply. But once a release price is agreed upon, there should only be minimal added transaction costs. For example, the bank must agree to the release, but there is little reason for the bank to object. Similarly, the bank must recall its first standby letter and issue a modified version in its place. The bank will charge an extra fee for the paperwork, but the administrative burden should be relatively light since all parties agree to the exchange.

Although a precise measurement of the costs incurred under each Rule is not possible, Rule II seems to involve fewer substantial transaction costs. Even though negotiation guidelines are lacking, the release negotiations should require less in transaction costs than the payment of the standby letter, the reimbursement of the bank, and the subsequent litigation required to reverse the penal forfeiture under Rule I. Even if one were to argue that the transaction costs incurred under both Rules are roughly comparable, Rule II would still seem preferable because it obliges X to perform in a manner more consistent with his original promise. Thus Rule II has this "moral advantage" over Rule I.

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117. Clarkson, Miller, and Murio, *Liquidated Damages v. Penalties: Sense or Nonsense*, 1978 WIS. L. REV. 351, 361 n.34. But see Comment, *Liquidated Damages and Penalties Under the Uniform Commercial Code and the Common Law: An Economic Analysis of Contract Damages*, 72 NW. U.L. REV. 1055, 1079 (1978).

## V. CONCLUSION

This Article has concluded that the presence of a standby letter of credit can act to enforce a penalty clause. When one recalls that penalty clauses are normally not enforced, this conclusion may seem surprising. But upon deeper analysis, this surprising conclusion emerges as the correct conclusion.<sup>118</sup> The presence of the standby letter usually bespeaks a transaction involving sophisticated businessmen. In such a transaction, the risk of unconscionability is greatly reduced. When a penalty clause results from fair bargaining between contracting parties, there is little reason to deny it enforcement. But a problem still remains. In order to create an enforceable penalty clause, contracting parties must incur the added transaction costs necessitated by the standby letter. The law seems to be adjusting to an overbroad and unwise rule (the general prohibition against enforcing penalties) in a rather hesitant and incomplete manner. The decision whether or not to enforce a penalty clause should not be based on the ability of contracting parties to incur these added costs. If the presence of a standby letter usually signifies a transaction free of unconscionability, then it is this factor, not the presence of the standby letter, that should determine whether the penalty clause should be enforced.<sup>119</sup>

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118. *Contra* Gable, *Standby Letters of Credit: Nomenclature Has Confounded Analysis*, 12 LAW & POL'Y INT'L BUS. 903, 942-43 (1980).

119. See Goetz and Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 594 (1977).

